No. 11417

In the United States Circut Court of Appeals for the Ninth Circuit

Commissioner of Internal Revenue, Petitioner

v.

National Reserve Insurance Company, Respondent

ON PETITION FOR REVIEW OF THE DECISION OF THE TAX COURT OF THE UNITED STATES

BRIEF FOR THE RESPONDENT

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The statement of facts set forth in petitoner's opening brief is substantially correct and the question to be determined is really one of law, to-wit: whether the Mortuary and Reserve Fund, which, it is admitted by petitioner, was established and maintained by respondent in strict conformity with the law of Arizona and the requirements of its Corporation Commission, justified the Tax Court in holding respondent to be a life insurance company within the meaning of Sections 201 and 202 of the Internal Revenue Code. Petitioner does not contend that this fund was not sufficient at all times to meet all the requirements of the American Standard Mortality Table on the basis of 3½% for the "fulfillment" of respondent's insurance contracts, after deducting from said fund all withdrawals made or permitted therefrom during all of the time involved herein, or that the reserve so maintained was not more than 50% of all the total reserve funds of respondent.

As we understand his argument, it is that because certain withdrawals were permitted to be made from the reserve fund thus maintained, it lost the character which it otherwise would have had as a proper reserve fund "held for the fulfillment of such contracts" as were issued by respondent for life insurance and annuities so as to qualify it as a life insurance company under Sections 201 and 202, supra, or to put it more definitely, that any reserve from which funds could legally be withdrawn for any purpose except annuities or payment of **death claims** under life insurance policies, could not qualify under the Federal statue, no matter though such reserve was at all times required by State law to be and actually was maintained sufficient to fulfil **all** the provisions of its insurance and annuity contracts.

What are these matters which the petitioner contends removes respondent's Mortuary Fund from the required status? They may be divided into four (4) groups. The first is a small number of bills which were erroneously charged in the books to the Mortuary Fund but which obviously should have been charged to the expense fund maintained by respondent. Petitioner tacitly admits that these items, which the evidence shows were merely errors in bookkeeping and not intentional charges to the wrong fund, cannot be considered as showing that the Mortuary Fund does not properly qualify under Sections 201 and 202 supra, so we say no more in regard to them.

The second class of charges which petitioner contends disqualified the Mortuary Fund maintained by respondent are those allowed under Article XVI of the by-laws of respondent, and the insurance policies issued thereunder, which article reads so far as material, as follows:

> "The Money in the Death Benefit Fund shall be used for the payment of death losses, however, the Board of Directors may set aside a portion of the savings in said fund for the purpose of organizing a legal reserve life insurance company, and shall issue in January of every year beginning January 1936 a certificate of evidence to each member of the Association who has paid twelve consecutive monthly payments without lasping, showing his or her pro rata in such savings."

As this court well knows, the premiums of a life insurance company are supposed to be sufficient to cover:

(1) The necessary reserves to fulfil its insurance contracts; and

(2) An amount sufficient to pay all the overhead expenses of operating the company.

In order to be sure that this is done, it is the custom of life insurance companies to charge a premium sufficient to fully meet these two requirements under all conceivable conditions, and almost invariably it is found at the end of the year that the premium charged and paid was larger than was necessary. This is a saving or surplus which in a stock company belongs to the corporation and may be used to pay dividends, properly so-called, to the stockholders, or for any other purpose within the articles of incorporation. In a non-profit mutual company, such as respondent, however, this excess belongs to the **policy holders** and not the **corporation** and is not a true **dividend** but a refund to the policy holder **in accordance with his insurance contract.**

> Equitable Life Ass. Soc. v. Brown,
> 213 U.S. 25, 63 L Ed. 682.

United States L. Ins. Co. v. Spinks
126 Ky. 405, 96 SW 889, 209 U.S. 539,
52 L Ed. 917.

Penn Mut. L. Ins. Co. v. Lederer,
252 U.S. 523, 64 L. Ed. 598.

It is true Sec. 19.203 (a) (2)-1 of the Regulations, states that these refunds are not to be considered as part of the reserve under Sections 201 and 202, supra.

Assuming this regulation to be a valid one, the record shows respondent did not attempt to include these refunds as part of the reserve which it contends qualifies it as a life insurance company under those sections. T.R. 81, 82.

The factual situation shown by the record is as follows: Sec. 53-609 AC 1939 requires that a mortuary and reserve fund be fixed by the Corporation Commission for the purposes set forth therein.

Pioneer Mut. Benefit Assn. v. Corp. Com.
123 Pac. 2d 828.

This was done by setting aside a certain percentage of the premiums. For the reasons above set forth, this was more than was needed to maintain the reserve for death claims required by Sections 201 and 202, supra, which had been calculated under the American Standard Mortality Tables at 3½% interest. T.R. 119. This surplus, or savings, belonged to the existing policy holders, pro rata. Unless in some manner it was legally withdrawn, it would remain in mortmain forever. According to petitioner's theory the only manner in which this could have been done, and still qualify the respondent as a life insurance company, would have been to **retain** this savings as a **deferred** refund, payable only at the **death** of the policy holder, or perhaps

to transfer the savings annually to another fund by order of the directors, and **then** refund to the individual policy holders from the new fund thus created.

The effect of the first course was well illustrated in the famous insurance scandals at the beginning of the century, as a result of which most states prohibited the deferred dividend, while the second course was in substance, though not in form, that actually followed by respondent under the direction of the Corporation Commission. T.R. 82. Under the plan followed it was impossible for the Mortuary Reserve to be depleted below the requirements of the Federal Statute by **reason of these refunds.**

It would be indeed a harsh and extremely technical construction to hold that Congress intended when it enacted Sections 201 and 202, supra, that the procedure followed by respondent under the orders of the Corporation Commission deprives it of its character as a life insurance company. The old saying "the letter slayeth but the spirit giveth life" is as true today as it was two thousand years ago. Our courts have held repeatedly that any doubt or ambiguity in the law should be resolved in favor of the tax payer, and it was never intended that our tax officials should, like Shylock, demand their pound of flesh.

The third class of payments which petitioner contends disqualified respondent's reserve fund, consisted of the payment of certain expenses, such as attorneys' and investigation fees, from the Mortality Fund. We think the construction placed by petitioner on the nature of these payments is both illogical and unwarranted. The Mortality Fund must be held to protect the "fulfillment of such contracts." According to petitioner's contention, the only "fulfillment" of a contract is

when a claim which is made thereunder is paid without investigation as to whether the contract requires its payment or not, and the employment of an investigator to determine the facts or an attorney to resist the payment of an unjust claim is not in "fulfillment of such contract." We think it is just as essential to the "fulfillment" of a contract to defeat an unjust claim thereunder as it is to pay a just one. Suppose for instance, a claim is made for a certain sum under a contract, when the officers of the company have reason to believe that all the facts, when they are discovered, will show that no payment is due. Is it not in "fulfillment of such contract" to investigate and determine those facts? Certainly if the claimant brings suit on such a claim against a company, the employment of competent attorneys to resist the claim is in "fulfillment of such contract." The record shows that payments of this class were only made in reasonable amount and under circumstances that would justify the investigation of the **particular contract** to see whether it would be a "fulfillment" thereof to pay it or fight it. T.R. 121. Evidently the Arizona legislature considered these matters as properly connected with fulfillment of insurance contracts rather than general expenses, (Sec. 53-609, AC 1939) and the Corporation Commission watched carefully to insure they did not unduly deplete the reserve fund. T.R. 121.

This covers the three principal objections made by petitioner to the sufficiency of respondent's reserve fund. The fourth is that the Arizona law permits interest earned by the fund to be used for general expenses. Section 53-609 AC 1939 is cited as authorizing this. On the contrary it explicitly states that such earnings are **not** to be used for operating expenses. Both respondent

and the Arizona Corporation Commission used the American Standard Mortality Tables in calculating the reserve fund. These tables are based on the theory that the amount needed is composed of certain funds paid by the policy holder **plus 3½% interest thereon.** Necessarily the interest earned by respondent was required by the law and regulations of the Corporation Commission to be added to the reserve fund to maintain it **as it was calculated,** and the presumption is that the law was complied with. There is no evidence to the contrary.

Petitioner states that the District Court held in First Nat. Ben. Soc. v. Stewart, which was appealed to this court and affirmed in 152 Fed. 2d 298, "The permission to use interest accretions from reserve funds for general expenses violates the requirements for an insurance reserve fund set out in Sec. 19. 203 (a) (2)-1" (Pet. Brief, p. 31). It is true that the conclusions of law of the District Court do in substance hold that the Arizona Code permits interest to be used for general expenses, but in view of what we have pointed out in the preceding paragraph, we think the conclusion is necessarily erroneous. No state court has ever so held.

Petitioner also relies strongly on the case of First National Benefit Society v. Stewart, 134 Fed. 2d 438, decided by this court. We have examined the case carefully and fail to see its applicability to the present situation. It was tried in the District Court of Arizona and was a suit asking for refund of a payment claimed to have been eroneously made, on the ground that the petitioner had paid a tax not required by law. The vital issue was whether petitioner was a life insurance company under Sections 201 and 202 supra. Among the findings of fact by the trial court were the following:

> "The plaintiff was not required either by express statutory provisions or by the rules and regulations promulgated in the exercise of a power conferred by statute to create or maintain a reserve for the fulfillment of its insurance contracts.
>
> "The plaintiff has not voluntarily created or maintained a reserve fund for the fulfillment of its life insurance contracts."

At that time, the State statute requiring the reserve fund under which respondent herein is operating, was not in force, nor did the evidence show a proper reserve was **voluntarily** maintained. The findings were obviously based on a factual situation very different from that existing in the present case. The matter came before this court on appeal, and the judgment was affirmed on the grounds that the regulations of the Treasury Department required a certain reserve in order for petitioner to qualify as a life insurance company under Sections 201 and 202, supra, and that the evidence failed to show that a statute, rule or regulation of the State of Arizona required such a reserve or that one had been voluntarily kept. The court in considering the evidence, stated:

> "The evidence goes no further than to show that appellant classified its income, but classifying income is not maintaining a reserve. Likewise, a requirement of the by-laws requiring maintenance of reserves does not show that appellant maintained such reserves."

In the present case the Tax Court, on sufficient evidence, found that a reserve of the nature required was maintained, ample in amount to fulfill all insurance contracts, and that it was maintained in accordance with the requirements of the law of Arizona. We cannot see the applicability of the case cited.

In the case of First National Benefit Society v. Stewart, 152 Fed. 2d 298, which was similar in nature to the previous cited case, this court said:

> "Appellee denied that appellant was a life in-insurance company within the meaning of Section 201 (a). On this issue, appellant had the burden of proof. Thus appellant had the burden of proving that it was engaged in the business of issuing life insurance and annuity contracts, and that its reserve funds held for the fulfillment of such contracts comprised more than 50% of its total reserve funds. The burden was not sustained."

In other words, the sole matter determined by this court in the case last cited was that the appellant did not sustain the burden imposed on it of showing that its reserve funds held for the "fulfillment" of its life insurance and annuity contracts, comprised more than 50% of its reserve funds. In the present case, this burden was successfully maintained, as found by the Tax Court. We have examined all of the cases cited in petitioner's brief and we have been unable to find any holding that a reserve of the type maintained by respondent in the present case, is insufficient to fulfill the requirements of Sections 201 and 202 supra, or the regulations adopted under them.

While some of the points raised in this case by petitioner were not expressly raised and decided in Reliance Benefit Association v. Com. 2 T.C. 15, yet the only reasonable implication from the decision of the Tax Court in this case is that it considered that case as sustaining the position of respondent that the reserve maintained by it qualifies under Sections 201 and 202, supra. The statute and regulations quite properly require that insurance companies set up sufficient re-

serves to guarantee that they will live up to their contracts, but it is a harsh, unreasonable and unjustified construction of the statute and regulations to say that the reserve fund maintained by respondent, which unquestionably sufficiently guarantees the fulfillment of **all** its insurance contracts, is not within the statute.

Counsel for petitioner has quoted approvingly and at length from the case of General Life Insurance Company v. Commissioner of Internal Revenue, 137 Fed. 2d, 185. We quote from the same case:

> "It is hardly conceivable that the policy of Congress was to exempt large, old line, fixed-premium life insurance companies, with its risks variedly spread over wide areas, and which had large reserves maintained by interest earnings, from taxation of premium income and to deny the benefit of the exemption to younger, smaller, and weaker life insurance companies, with their risks largely localized, and which had not yet built up a reserve sufficiently large for the investment income to maintain the reserve in the event of serious local epidemics or disasters. To so hold would be to attri bute to Congress a misdirected discrimination in favor of the strong over the weak. To give effect to Treasury Department Regulation No. 94, as construed and applied by the Commissioner, would tend to deny the benefits of the exemption to the companies that needed it most. It is not thought that this was the intention of Congress."

In the present case, to hold that a reserve maintained in strict accordance with the laws of the State of Arizona, and admittedly always actuarilly sufficient to protect the "fulfillment" of its insurance contracts under a reasonable construction of what "fulfillment" requires, was insufficient to qualify respondent as an insurance company under Sections 201 and 202, supra,

would certainly tend to deny the benefits of the tax exemption granted by Sections 201 and 202, supra, to one of the companies which needed it the most. We submit that the judgment of the Tax Court should be affirmed.

Respectfully submitted,

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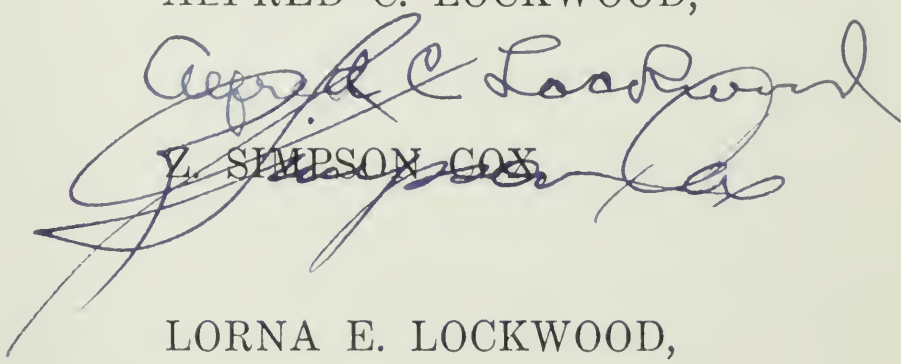

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